

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 5634]
March 19, 1965]

INTERPRETATION OF REGULATION U

To All Banks in the Second Federal Reserve District:

Printed below is a copy of the substance of a reply from the Board of Governors of the Federal Reserve System to a recently submitted question whether a bank may, in conformity with the requirements of section 221.3(a) of Regulation U (Loans by Banks for the Purpose of Purchasing or Carrying Registered Stocks), accept purpose statements that are submitted by mail under a plan for making loans against mutual fund shares. The reply will be published shortly in the *Federal Reserve Bulletin* and the *Federal Register*, but the substance is being sent to you now so that you may have prompt notice of its content.

Additional copies of this circular will be furnished upon request.

ALFRED HAYES,
President.

Loans by Mail on Security of Mutual Fund Shares

The Board of Governors has been asked whether a bank can accept in good faith, within the meaning of section 221.3(a) of the Board's Regulation U, "nonpurpose" statements submitted by mail in connection with a widely-publicized plan under which the bank offers to make installment loans up to 70 per cent of the redemption value of shares of open-end investment companies ("mutual funds") that are pledged by the borrower as collateral. A customer may either go personally to one of the bank's offices, or mail in a loan application. The problem before the Board does not arise unless he chooses to apply by mail.

loan is "directly or indirectly" for the purpose of purchasing or carrying stocks registered on a national securities exchange (so-called "purpose loan"), and places upon the bank the responsibility for taking appropriate action to determine the actual purpose of a proposed loan.

Mutual fund shares are "stock" for purposes of Regulation U, and under section 221.3(b)(2) shares issued by many such funds are deemed to be registered stocks. Consequently, the loans are secured by stock, and are purpose loans if they are for the purpose of purchasing such mutual fund shares (or other registered stocks). At present, a bank may lend no more than 30 per cent of the current market value of stock collateral if the loan is a purpose loan, so that the regulation would forbid the making of a loan under the plan if, despite the borrower's statement to the contrary, the bank should have known that it was really a purpose loan.

Section 221.3(a) of Regulation U permits a bank to rely on a statement by the borrower as to the purpose of a loan

"... only if such statement (1) is signed by the borrower; (2) is accepted in good faith and signed by an officer of the bank as having been so accepted; . . ."

Under the plan submitted, the borrower completes the following statement on the application form:

"I/We state that this loan is for the following purpose (describe briefly):

.....
and that it is not for the purpose of purchasing or carrying mutual fund shares or any securities registered on a national securities exchange."

Regulation U, of course, limits the amount a bank may lend against collateral consisting of stock, where the

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and the regulation explains that

"... to accept the statement in good faith, the officer must be alert to the circumstances surrounding the loan and the borrower and must have no information which would put a prudent man upon inquiry and if investigated with reasonable diligence would lead to the discovery of the falsity of the statement."

The bank's manual of instructions to its employees with respect to this plan indicates precautions which are to be taken in attempting to ensure that the statement can be accepted in good faith. For example, if a check is to be mailed to the borrower in care of a broker or dealer, a purpose statement may be required from the latter. Delivery to the bank as collateral of a certificate dated shortly before the loan application would indicate the need for further inquiry. Repeated loan applications with certificates dated subsequent to prior loans would also suggest the possibility of a violation.

Although these precautions are useful and demonstrate the effort the bank has made to bring the plan into conformity with the regulation, the Board does not believe it would be feasible, under the circumstances described, for the circumstances surrounding each loan to be sufficiently known to the loan officer so that the officer could become aware of circumstances that might indicate a need for further investigation. While no precautions can completely eliminate error or evasion, the Board believes there is no satisfactory substitute for a face-to-face meeting between borrower and lending officer in developing information as to the purpose of a loan. The regulation makes the officer responsible for determining the purpose of a loan, and it is difficult to see how he can discharge this responsibility, particularly when numerous loans are made on a uniform basis, without an opportunity to question the customer. In addition, a customer relationship, or the possibility that such a relationship may arise in the future, tends to put both customer and loan officer on a more realistic footing in respect to Regulation U.

While it is true that not all stock-secured loans involve personal interviews between borrowers and loan officers, or a customer relationship, these do obtain in the normal case. Loans made by mail under the plan put into operation by the bank would tend to create a new class of stock-secured loan, to be made in relatively small amount for each loan, and poten-

tially made in large numbers, so that the absence of these safeguards would be especially likely to result in the making of "purpose" loans that exceeded the permissible amount. Accordingly, the Board does not believe that a purpose statement submitted by mail in connection with a plan of this kind can satisfy the requirements of section 221.3(a).

Another problem that may arise under the plan remains to be discussed. In 1962 *Federal Reserve Bulletin* 690, the Board held that certain loans to be made by a bank against stock of American Telephone and Telegraph Company, although earmarked for "living expenses", must be considered to be purpose loans where the borrower was simultaneously purchasing additional shares under an employee stock purpose plan, and the loans were to be geared to the amount of the monthly installment payment required. The Board pointed out that payroll deductions to finance purchases under the plan could be as high as 38 per cent of base pay, and a larger percentage of "take-home pay", and that deductions of this magnitude are in excess of the savings rate of many employees.

It may be asked whether this interpretation applies to loans made by the bank under the present plan, if the borrower is simultaneously purchasing mutual fund shares under a periodic purchase plan, regardless of the use he may make of actual proceeds of the loan. The Board believes that the principle of the 1962 interpretation would apply where a purchaser is obviously buying more stock than he can carry out of current income, or where loan disbursements are geared to payments under such a purchase plan, and that in such cases, the lending bank should treat the loan as a regulated loan.

Since information normally obtained by lending officers would reveal whether the borrower was purchasing stock under such a plan, and whether the purchases were disproportionate to the borrower's income and other expenditures, it should not be difficult for the officer to make a judgment on this point. The existence of this question, however, provides an additional reason why a personal interview is advisable in the case of a loan against mutual fund shares, if the bank is to make a reliable determination as to whether or not the loan is a purpose loan and subject to the regulation.